Economic Update

Committee on the Budget ▪ Majority Caucus
U.S. House of Representatives
Jim Nussle, *Chairman*

309 Cannon House Office Building
Washington, DC 20515 ▪ (202) 226-7270
Rich Meade, *Chief of Staff* ▪ www.budget.house.gov

Volume 2, Number 4 13 May 2003

Foundation Being Laid for Stronger Growth

Over the past 6 months, the U.S. economy continued to be largely stagnant, with slow growth of real gross domestic product [GDP], declining payroll employment, falling consumer confidence, and rising unemployment. Treasury Secretary Snow recently called the economic recovery "soggy." Hopeful signs exist, however, that the resolution of the military conflict in Iraq, and the expectation of additional tax relief now working through Congress, are laying a foundation for a return to stronger economic growth and an improved labor market.

Economy Even Weaker Than Expected

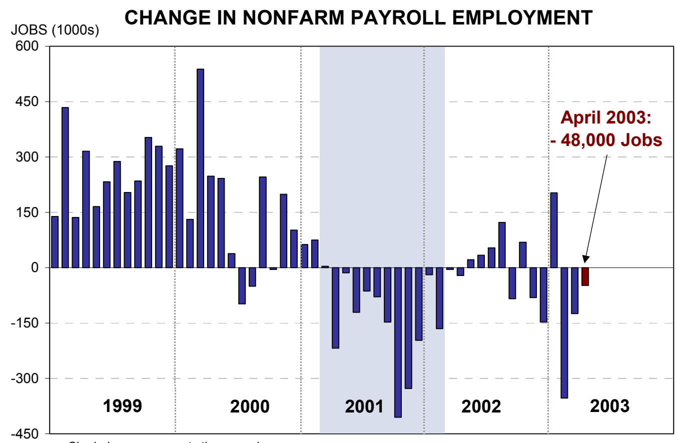
From the autumn of last year through the early part of this year, the U.S. economy continued to struggle. Last November, the Federal Reserve had called the sluggish performance the "current soft spot."

In fact, the economy's performance has been somewhat worse than anticipated at that time. Real GDP grew at only a 1½-percent annual rate over the fourth quarter of last year and the first quarter of this year. The manufacturing sector and consumer confidence exhibited outright declines. Labor markets also have worsened, with the unemployment rate rising to 6.0 percent in April and payroll employment falling significantly. With the loss of 48,000 jobs in April, the decline in payroll employment over the past 3 months exceeded a half million jobs (see chart).

Tentative Signs Suggest Improvement

Although only limited data are available at this time for the post-Iraq conflict period, initial observations tentatively suggest an improving economic outlook.

- The stock market has been on a steady upward trend in recent weeks, rising more than 15 percent from its pre-Iraq lows.



Shaded area represents the recession.

- Consumer confidence and sentiment improved in late April, showing a bounce back from the lows that occurred during the uncertain period leading into the Iraq conflict.

- Weekly chain store sales (as compiled by the Bank of Tokyo-Mitsubishi) rose sharply at the end of April and the beginning of May, compared with early April levels.

- Weekly unemployment insurance [UI] claims have fallen in the past 2 reporting weeks from their mid-April highs (which had been the highest level in more than a year). Despite the improvement, however, UI claims remain above the 400,000 level that is typically viewed as indicating a neutral labor market.

- Crude oil prices declined by about $10 per barrel from their pre-Iraq conflict peaks of almost $40 per barrel. Similarly, retail gasoline prices have declined by more than 20 cents per gallon from their pre-war highs in March.

(continued on reverse side)

- Financial market perception of private corporate risk has declined sharply over the past 2 months. For example, the spread between corporate BAA bond yields and Treasury yields – a measure of the perceived riskiness of private business debt – peaked last fall at nearly 4 percentage points, but recently fell to just above 2½ percentage points. Lower corporate interest rates mean a lower cost of capital that firms face when making investment decisions.

Nevertheless, it will be some time before a return to sustained, stronger growth can be confidently predicted. The initial monthly data reports for April, which will come out this month, will still include significant amounts of data from the periods prior to and during the Iraq conflict. For example, the Employment Situation report that showed the loss of 48,000 jobs and the rise in the unemployment rate to 6.0 percent resulted from surveys conducted in the week of 12 April, in the midst of the Iraq uncertainty. Ultimately, several months of good data will be necessary to be confident that a rebound is in fact genuine and sustained.

The Blue Chip Outlook

Private forecasters, while concerned about the downside risks, do expect that the economy will improve significantly by the second half of this year (see chart). The Blue Chip consensus forecast shows the rate of real GDP growth exceeding 3½ percent over the second half of this year and through 2004 as well. The unemployment rate is expected to initially stay relatively high (around 6.0 percent), and then decline only gradually; for 2004, the unemployment rate is expected to average 5.7 percent. But the Blue Chip forecasters are not highly confident: 64 percent of the forecasters surveyed believed risk to the forecast for growth in the second half of this year was to the downside.

Blue Chip Economic Outlook, May 2003

	2002.4	2003.1	2003.2	2003.3	2003.4	2004 Avg.
			(percent)			
	------- History -------					
Real GDP Growth	1.4	1.6	2.1	3.5	3.7	3.6
Unemployment Rate	5.9	5.8	6.0	6.0	5.9	5.7
CPI Inflation	2.0	3.8	1.7	1.7	1.9	2.3
3-month Treasury Bill	1.3	1.2	1.2	1.2	1.4	2.4
10-year Treasury Note	4.0	3.9	4.0	4.2	4.4	4.9

Note: For 2004, rate of change is for 4th quarter 2003 to 4th quarter 2004; annual average levels for unemployment and interest rates.

Fed Policy on Hold

Despite the ongoing weakness in the economy, the Federal Reserve's policy committee – the Federal Open Market Committee [FOMC] – decided at its meeting on 6 May not to lower interest rates. The FOMC last lowered rates at its November meeting, when it cited the economy's "current soft spot." Since then, as described above, the economy has been even weaker than anticipated at that time, with real GDP growth only at a 1½-percent rate, and payroll employment falling by more than one-half million jobs. Meanwhile, the "core" consumer price inflation rate (excluding food and energy) has fallen further – to less than 2 percent over the past year and less than a 1-percent annual rate over the past 3 months. Hence, rising inflation is not a legitimate concern at this time; in fact, the Fed cited the higher probability of "an unwelcome substantial fall in inflation."

Congress Works to Pass Tax Cuts

Recognizing the need for additional policies to help promote sustained growth in the economy and in jobs, both houses of Congress have continued to work toward adopting additional tax relief. The House last week passed H.R. 2, which provides $550 billion of additional tax relief policies. (For a description, see *Legislative Update*, Volume 3, Number 1, 8 May 2003). The Senate is beginning consideration of a net $350-billion measure reported by the Senate Finance Committee.

In terms of how much short-run stimulus would come from these proposals, the House has the largest amount ($204 billion over fiscal years 2003-04), compared to the President's proposal ($154 billion), and the Senate's ($143 billion). Relative to the size of the economy, those 2-year amounts represent about 2 percent of GDP (at the House level), and about 1½ percent of GDP (at the Senate level). Various estimates have been made about the likely employment benefits of such proposals, but stimulus of these magnitudes would be expected to help boost employment by about 1 million to 1½ million jobs by the end of 2004. A recent dynamic analysis of the macroeconomic effect of H.R. 2 (*Congressional Record*, 8 May 2003, H3829-3832), by the Joint Committee on Taxation, confirmed that the tax relief would boost real GDP and employment over the 2003-08 period.

Prepared by .... John H. Kitchen
Chief Economist